industry-wide rate of return that may be both unconstitutional as applied to individual cases and arbitrary.

In establishing a rate of return, moreover, the Commission cannot ignore that its rate regulatory scheme for cable television already threatens the industry's access to capital markets.[39] It should not compound these difficulties by unreasonably tipping the balance toward the lower end of the "zone of reasonableness." This would occur if the Commission adopted a single rate of return based on the cost of capital to an inappropriate surrogate group.

A. The Commission Should Not Establish a Single Rate of Return for the Provision of Regulated Cable Service

The Notice proposes "to establish a single rate-of-return for provision of regulated cable service by all cable operators for the purpose of setting rates based on a cost-of-service showing."[40] This proposal stems from a fundamental misunderstanding of the nature of the cable industry and from the erroneous notion that "the factors on which a rate-of-return is based are [not] likely to be so different that it is necessary to establish separate rates of return."[41] Insofar as the cost of capital is a function of the business and financial risks peculiar to that entity,[42] adoption of a single generic allowed return for the

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39 See Letter from 18 Lending Institutions, MM Docket No. 92-266 (filed June 21, 1993) (noting that as a result of the benchmark methodology and its disincentives to system expansion, "many operators will need to seek amendments of their financial covenants. Others may have to direct funds from capital expenditures, raise additional equity, or amend their debt amortization schedules to meet existing debt repayment obligations. While the strongest cable operators will have financing options, the smaller 'all cable' operators will find all forms of capital elusive.")

40 Notice ¶ 46.

41 Id.

42 Phillips, The Regulation of Public Utilities (1988) at 363.

entire industry is inappropriate. Instead, the allowed rate of return should be based on the cost of capital applicable to the cable system for which rates are being set.

The required return for investors in the cable industry is a function of the risks associated with the particular cable company. Risks for the more than 11,000 cable systems in the United States vary widely. Cable systems differ in size, channel capacity, subscriber density, age, and the level of competition they face. Unlike typical regulated utilities, penetration differs from system to system, and, due to subscriber churn, from month to month. All of these factors make it impossible to equalize the risks to which each system is exposed.

In addition, unlike utilities that have fairly uniform debt to equity ratios, cable systems have markedly different capital structures. Unlike mature businesses, cable systems in general have a higher debt to equity ratio than other industries, because of their need to deploy capital to expand capacity, service new customers and offer new program services. The opportunities available to individual companies vary widely and depend on many factors, including company size, payment history, stability of subscriber base, and the local regulatory environment.[43] Their cost of capital can be expected to differ significantly as a result.

This heterogeneity of the cable industry is reflected in significant differences in riskiness of equity capital among individual cable companies. Appendix B describes the difference in risk estimates, measured by betas, of the equities of six large cable companies. These betas range from a minimum of 1.03 to a maximum of 1.53. Such large differences in betas suggest that different cable companies may have very different

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[43] While the Notice suggests employing a hypothetical 50% debt/50% equity ratio in determining the cost of capital for the industry, this predetermined capital structure is not warranted. In the short term, using a hypothetical, rather than actual, capital structure will not accurately reflect a cable system's financial needs. As such, it will not provide an adequate opportunity to justify rates based on those needs.

costs of equity. Other things being equal, an operator with higher equity costs is also likely to have high debt costs. And the cost of capital for smaller cable operators is likely to be higher than that for large operators.

Given the wide range of risk attendant to individual companies in the industry, it would be irrational to attempt to impose an industry-wide rate of return.[44] Each cable system should be allowed to establish an appropriate rate of return based on its financial condition. This process should be based not on a surrogate, but on an examination of the cable system's cost of debt and preferred stock to determine their embedded cost and an analysis of the cost of equity peculiar to that system.

B. The S&P 400 is Not an Appropriate Surrogate

The Commission tentatively concludes, without any supporting data, that "the S&P 400 offers a broad range of investor expectations of the trade off between risk and return, and that investors in S&P 400 firms experience risks of economic loss that are roughly equivalent to those experienced in the provision of regulated cable service."[45] But this is not the case.

There is no basis on which it could be concluded that the business and financial risk of a particular cable company, or even the aggregate of all cable companies, is comparable to some aggregate measure of risk for the S&P 400. In fact, the market risk

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[44] Prior regulatory experience with the generic determination of rate of return demonstrates that such an approach is of dubious value. In 1984, the Federal Energy Regulatory Commission began publishing quarterly a generic rate of return for the electric industry. The FERC was unwilling to advocate its mandatory use in ratemaking, and made clear that it was an advisory determination only. After 7½ years, the FERC concluded that it was of little value even for that limited purpose and its publication was discontinued. FERC Order No. 538, 57 FERC 802 (1992). If a generic return determination for the electric industry is unworkable, it is clearly inadvisable for the more volatile circumstances of the cable industry.

[45] Notice, ¶ 50.

of cable operators examined in Attachment B exceed the risk in the market as a whole by 30 to 50 percent.[46] This being the case, any attempt to measure a risk premium for cable companies on the basis of relative equity costs of the S&P 400 would amount to pure conjecture.

Moreover, the Commission itself notes that its end result is a cost of equity for a median S&P 400 company.[47] By definition, therefore, half of the S&P 400 themselves would require a higher return. This median return is then to be applied to <u>all</u> cable companies, all of which could be riskier than the median S&P 400 company. If the generic figure is somehow supposed to be a required average return for cable companies, it must perforce be inadequate for half the cable companies to which it would apply.

The Commission would then compound the uncertainty of its methodology by using this conjectural equity return requirement with a hypothetical capital structure that may have little to do with the capital costs of any given cable company. If the resulting overall return coincided with the capital cost of any cable system, it would only be through sheer accident.

It is widely accepted, as the Commission notes,[48] that equity return determination is a matter of judgment. However, throughout regulation, it is recognized that in exercising that judgment, a Commission must proceed reasonably, using relevant data in a logical and coherent analysis to support its conclusion. The suggested use of the S&P 400 set forth in the <u>NPRM</u> simply does not meet the most minimal standards for acceptable regulatory analysis.

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[46] Appendix B at 5.

[47] <u>NPRM</u>, n.57.

[48] <u>NPRM</u>, ¶ 51.

C. Telephone Companies Are Not a Suitable Surrogate

The Notice also solicits comment on whether regulated telephone companies should be used as a surrogate.[49] Telcos are an entirely inappropriate surrogate for the cable industry. Unlike telephone companies, cable systems do not provide an essential service.[50] In fact, nearly 40 percent of the households that could subscribe to cable choose not to do so. As Appendix B demonstrates, telephone companies face a risk much different from -- and lower than -- cable companies. Based on Value Line estimates, telcos' betas range from .85 to .95, as compared to ranges of 1.35 to 1.55 for the cable systems analyzed.[51] If cable companies are substantially riskier investments than telephone companies, it follows that they must earn a substantially higher rate of return to attract capital.

D. Test Year Definition

The NPRM observes that regulators traditionally use a "test year" to measure "a regulatee's operating experience during a twelve-month period as a basis for determining representative levels of revenues, expenses, rate base and capital structure."[52] It proposes three test year alternatives for cable systems; historical test year, future test year or a combination thereof. It asks whether one of these alternatives should be used in all cases.

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49 Id.

50 See Duquesne, 488 U.S. at 315 (noting that "[u]tilities are virtually always public monopolies dealing in an essential service, and so relatively immune to the usual market risks.")

51 This measure may well understate cable systems' relative riskiness, and overstate that of the telephone companies. The Commission has previously recognized that Value Line betas are adjusted to raise the level of betas less than one and to lower the level of betas greater than one. Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, 5 FCC Rcd. 7507, 7523 (1990).

52 NPRM at ¶ 55.

Before mandating a uniform test year procedure, the Commission should have the benefit of some experience in cost-of-service ratemaking for cable systems. The reliability of historical experience as an indicator of future revenue requirement levels should be carefully evaluated on the basis of actual cost-of-service showings. This ultimately will allow the Commission to apply the procedure that most directly comports with the actual anticipated circumstances. All that is needed at present is a requirement that the test year method chosen by the cable operator be a reliable indicator of expected revenue requirements during the effective period of the rates to be set.

IV. THE COMMISSION SHOULD RESTRICT ITS REGULATION OF CABLE INDUSTRY DEPRECIATION PRACTICES TO MONITORING OF THESE PRACTICES

. Under the proposed original cost approach, establishing an appropriate pace for recovery of the capital invested in depreciable assets through annual depreciation charges is a necessary and potentially significant component of the cost-of-service rate scheme. For the cable industry, the NPRM suggests dealing with this issue by adopting, at the outset, an industry-wide depreciation rate or band of rates. But the Commission is wrong to consider, at this stage, anything other than monitoring of individual company depreciation practices.

Applying the resources initially needed to implement the cost-of-service rate scheme itself creates a challenge not easily met. Comprehensive supervision of depreciation rates and practices adds an enormously burdensome requirement to the rate setting process. In fact, the Commission has not even yet identified specific objectives of depreciation regulation for the cable industry.

In its simplest form, capital recovery must take account of the physical life of the plant in which the capital is invested. Determining the useful physical life of cable equipment would itself require more detailed study and analysis than is presently available to the Commission. However, in a business of advanced and changing technology like the cable industry, the Commission must take into account not only physical decay but also obsolescence caused by technological and economic changes. This requirement makes it even more complicated to determine the appropriate pace for capital recovery. It would be unreasonable for the Commission to prescribe an industry-wide rate at this threshold stage of its regulatory process.

Until now, cable industry depreciation rates have been unregulated. Cable operators have been depreciating property for tax and financial accounting purposes. In recent years, cable companies have begun the process of rebuilding their networks by replacing coaxial trunk and feeder plant with fiber, enhancing the ability of the plant to perform additional video and non-video functions, and improving service quality. Commission and franchisor policy has encouraged these practices. Because all systems will not be scheduled for rebuilding simultaneously, cable system depreciation rates will vary widely.

Adoption of cable industry-wide depreciation rates, whether as a single rate or a range of rates, will deny cable operators the ability to demonstrate the reasonableness of depreciation practices. There is no record, either before Congress or the Commission, that cable's depreciation practices have been unreasonable. To the contrary, the Commission has been encouraging the cable industry to deploy new technologies and offer new services for more than 20 years.[53]

Accordingly, the Commission should limit its regulation of cable industry depreciation practices to monitoring. If the Commission, nevertheless, decides to prescribe depreciation rates for cable systems, it must do so on a case-by-case basis. Cable systems, which have engaged in divergent depreciation practices fully consistent

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[53] See, e.g., Cable Television Report and Order, 36 FCC 2d 143, 144, n.10 (1972).

with existing law and policy, are owed at least the same procedural processes, and presumption of validity, as telephone companies.[54]

V. THE COMMISSION SHOULD PERMIT CABLE OPERATORS SUBSTANTIAL DISCRETION IN COST ALLOCATION THROUGH CASE-BY-CASE DETERMINATIONS

The NPRM asks for comment on the regulation of cable system cost allocation. As a general matter, it is important that cable operators be able to allocate their costs so

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[54] The Commission is familiar with the process required in establishing rates of depreciation of telcos. Pursuant to this process:

a. A carrier submits a depreciation study to the Common Carrier Bureau. The study consists of a variety of data related to the carrier's recent plant retirements and plans for future plant retirements (i.e., "basic data"), as well as the carrier's assessment of that data in estimating life and salvage parameters.
b. The Bureau independently analyzes the basic data and reviews the carrier's life and salvage estimates.
c. The Bureau prepares its own preliminary recommendations and forwards them to the state commission(s)[54] and the company in a review letter.
d. The Company's filings and the preliminary Bureau proposals are discussed at a conference in which representatives of the company, the staffs of the respective state commissions(s) and the Bureau participate (i.e., the three-way meeting).
e. The Bureau makes its final recommendations at the close of the three-way meeting.
f. The carrier formally files for revised depreciation rates. These filings may or may not be consistent with the Bureau's recommendations.
g. The Bureau issues a public notice requesting comments on specific changes in depreciation rates.
h. After considering the complete record, the Commission prescribes depreciation rates.

The Prescription of Revised Percentages of Depreciation pursuant to the Communications Act of 1934, as amended, for Alascom Inc. et al., 6 FCC Rcd. 750 (1991).

that they are fully recovered. A cable company's method of cost allocation, therefore, must be uniformly applied across all jurisdictions.

Cable operator cost allocation practices vary widely. It is too early in the process to understand which cost allocation method is appropriate industry-wide. The Commission's previous efforts to supervise telephone company costs demonstrate conclusively that when it comes to cost allocation, no quick fixes are available. Despite 30 years of trying, ongoing disputes persist on the proper ways to account for carrier costs, to assign costs among jurisdictional services, and to segregate jurisdictional and non-jurisdictional service costs.

For most of this period, the Commission focused on a single company, AT&T. Even after divestiture, a relatively small number of firms were investigated. Now, the Commission proposes to apply a version of these problematic procedures to a potentially larger universe of markedly different firms. The Commission cannot possibly accomplish what it intends in the time allowed. And regulatory misfires will unfairly threaten the viability of individual cable systems by preventing them from earning a reasonable return.

Over the long term, the Commission may choose to undertake for cable the extended and comprehensive proceedings that led, in the common carrier area, to the cost allocation, <u>Joint Cost</u> and related procedures. These less-than-satisfying regulatory devices were developed after much trial and error. Until the Commission completes that process for cable -- a process that has barely begun -- cable systems must not be forced into a single mold for allocating costs. Through the experience gained from case-by-case determination over time, the Commission can develop meaningful allocation rules.

In the meantime, the Commission already has adopted rules for cost accounting and cost allocation that require the exclusion from regulated cable service rates of expenses and other costs unrelated to the provision of regulated cable service.[55] The rules also prescribe broad cost allocation standards.[56] The Commission should allow cable operators to follow these rules until a fuller understanding of cost allocation is gained.

VI. THE COMMISSION SHOULD PURSUE "STREAMLINING" ALTERNATIVES BUT SHOULD NOT "STREAMLINE" THE COST OF SERVICE METHODOLOGY CHOICES OF ANY OPERATOR WHO CHOOSES FULL COST OF SERVICE

Noting the directive of the 1992 Cable Act to reduce administrative burdens arising from regulation on all concerned, the Commission proposes six alternatives. The alternatives plainly relate to the overall regulatory scheme, although some can apply also to cost-of-service. NCTA believes the Commission should pursue the streamlining alternatives in this and subsequent proceedings.

The Commission seeks comment on six alternatives:

- To permit cable systems to demonstrate the reasonableness of rates by showing that rates have not increased in excess of inflation since deregulation, less a productivity offset if appropriate;
- To take steps to alleviate the burden of regulation on small systems;
- To provide operators with the choice of basing equipment charges on nation-wide or regional average costs instead of requiring each system to calculate actual equipment costs;
- To enable operators to justify rates through an abbreviated cost-of-service showing for significant prospective capital expenditures used to improve the quality of service or provide additional services;
- To authorize operators to show the reasonableness of rates based on the average cost of providing cable service experienced in the cable industry; and
- To allow systems to justify existing rates based on key cost factors.

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55 47 C.F.R. § 76.924(f) and (g).

56 Id., § 76.924(e).

A. Rates That Have Not Increased in Excess of Inflation Since Deregulation Should be Found Reasonable

The ultimate test of the reasonableness of existing rates is, of course, a specific showing justifying the rates in a cost-of-service showing. However, requiring a detailed cost-of-service analysis and showing for every rate not in conformance with benchmark requirements will prove extremely burdensome for cable operators, for the Commission and for franchising authorities. Before requiring that a choice be made between a change in the existing rate based on benchmark requirements or a full-blown cost-of-service case, the Commission can base a reasonableness determination on an analysis of the cable operator's rate history during the unregulated period in light of inflation indicators. This approach is fully consistent with the Commission's willingness to rely on inflation indexing in applying price caps to future rates which begin from the benchmark base. If inflation indexing provides acceptable assurance of reasonableness in the future, it can equally be relied upon when applied ex post to existing rates. Moreover, adopting that approach is consistent with the 1992 Cable Act, which requires the Commission, in determining whether rates for cable programming services are unreasonable, to take into account "the history of the rates for cable programming services of the system, including the relationship of such rates to changes in general consumer prices."[57]

Prior to December 29, 1986, cable rates were generally subject to regulation by local franchising authorities. Effective at that time, the 1984 Cable Act deregulated rates for most systems. Congress found in 1992 that most cable systems operating in an unregulated environment had raised rates faster than the rate of the most commonly used measure of inflation, the Consumer Price Index. According to the legislative history, "The average monthly cable rate has increased almost 3 times as much as the Consumer

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[57] Act, Section 3(c)(2)B).

Price Index since rate deregulation."[58] But where a system's per-channel rates have not increased faster than the rate of inflation since deregulation, there is no basis for viewing existing rates as unreasonable. In such cases, rates higher than benchmark levels should be approved without requiring any further showing.

1. The Commission Should Not Adopt a Productivity Offset to the 1986-Forward Inflation Adjustment

The Commission asks, however, whether there should be a productivity offset to the rate of inflation for these purposes. There is no basis for such an offset. As explained in the study by Economists Incorporated attached as Appendix C, while the concept of a productivity offset has been applied in the context of telephone rate regulation, it is not applicable here.

Telephone companies are making a transition from a form of cost-of-service regulation to a form of "price cap" or "incentive" regulation. There has long been a concern that cost-of-service regulation of monopoly telephone companies may produce incentives for overinvestment in plant. Averch and Johnson pointed out long ago that where the rate of return of a regulated entity exceeds the cost of capital -- a condition which has often occurred -- the regulated entity may have an incentive to overinvest, thereby reaping additional profits.[59] Price cap regimes, at least theoretically, respond to these incentives by motivating the regulated company to perform like a competitive firm.[60] The productivity offset was adopted, in significant part, so that consumers could

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[58] Cable Television Consumer Protection and Competition Act of 1992, H.R. Conf. Rep. No. 862, 102d Cong., 2d Sess. 55 (1992).

[59] Averch and Johnson, "Behavior of the Firm Under Regulatory Constraints," 52 AMER. ECON. REV. 1052 (1962).

[60] See, e.g., Policy and Rules Concerning Rates for Dominant Carriers, 4 F.C.C. 2d 2873, 2893 (1989) ("The attractiveness of incentive regulation lies in its ability to

share a portion of the efficiencies resulting from regulatory incentives intended to wring the cost-of-service generated inefficiencies out of the telephone companies.[61] It was applied under circumstances very different than those present here, where cable operators are moving from a free market to a regulated environment.

Furthermore, few, if any, cable operators have kept programming and service quality constant since 1986. Instead, the quality of cable service has increased over the past seven years. The building blocks of cable service -- programming -- have not become cheaper; to the contrary, output, and associated costs, have risen over time. These quality enhancements differ from telco service, where dialtone service has remained more or less at the same level at the same time that provision of telephone service has become cheaper to offer through automation and greater use of electronic switching. Applying a productivity offset, to cable television, under these circumstances will reduce these rates below presumptively competitive levels. It will fail to take into account quality and service improvements since 1986. Accordingly, no productivity adjustment should be applied to per channel rates that have not risen faster than inflation since 1986.

2. The Commission Should Not Apply a Productivity Offset to the GNP-PI

For similar reasons, the Commission should not apply a productivity offset to the GNP-PI for future rate increases. As Appendix C describes, any adoption of a productivity improvement offset should be coupled with a much larger quality improvement offset. If no such quality improvement offset is allowed and regulated price increases are limited to a level less than inflation, future quality improvements will be

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replicate more accurately than rate of return the dynamic, consumer-oriented process that characterizes a competitive market.")

61 See, e.g., id. at 3223

reduced. The practical effect of a failure to account for continued quality improvement will be reduced demand for cable, injuring both program diversity and consumers.

In addition, there is no way to measure increases in cable productivity. And even if there were a measure of historical productivity, there is no economic basis to project that any past productivity increases will continue in the face of increased regulation. If anything, regulation of cable rates pursuant to cost-of-service showings may cause cable operators to operate less efficiently in the future.

B. Swift and Aggressive Steps Must Be Taken to Relieve Small System Burdens

NCTA has previously called upon the Commission to alleviate the regulatory burdens on small systems, as required by the Act. In the NPRM, the Commission asks what steps might be warranted.

NCTA's views on actions that the Commission should take with respect to small systems were set forth in a letter to Chairman Quello, submitted jointly with other organizations.[62] In that letter, we urged the Commission:

- To permit small operators to justify their current rates based on a simplified net income analysis. We believe that a simple comparison of total system revenues to operating expenses, depreciation and interest expenses for some specified prior period would demonstrate whether the system's current rates require any further examination. A net income analysis would be much simpler to calculate and apply than the benchmark approach.

- To permit small operators to increase rates to the benchmark cap. The Commission has found that rates at or below the national cap are "reasonable." By affording small operators presently charging rates below the cap the option to increase rates to the cap, these systems will retain the flexibility needed to generate necessary capital.

[62] Letter of NCTA et al. to the Honorable James H. Quello, July 13, 1993.

- To authorize small operators to base rates on the bundling of service and equipment charges. The requirement that operators "back out" equipment costs based on "actual cost" from the benchmark rates is a particularly onerous procedural requirement. The Commission should adopt a mechanism, such as the equipment averaging proposal discussed below, that does not force small operators to engage in these calculations.

- To allow small operators to pass-through rebuild costs. Small operators are generally located in rural areas. Congress and the Commission have long advocated special regulatory treatment to make state-of-the-art communications technology available to rural areas. Permitting small operators to pass-through rebuild costs will increase the chances that rural subscribers promptly gain the benefits of state-of-the-art technology.

- To commence a rulemaking addressing small system regulatory concerns. If the Commission does not exempt small systems from regulation in MM Docket No. 93-266 it should begin a proceeding that comprehensively examines small system issues.

We believe that these steps are the minimum necessary to alleviate the regulatory burden on small operators.

C. Cable Systems Should Be Given the Option to Base Equipment Charges on Nationwide or Regional Average Costs, or on Average Costs Based on System Characteristics

Equipment rate regulation is one of the most onerous aspects of the rate scheme. The statute directs the Commission to regulate the rates of certain equipment on the basis of the cable system's "actual cost."[63] Installation, converter boxes, remote control units and additional outlets are included.[64] The Commission has chosen to require cable systems to calculate the actual cost of every piece of equipment and the labor costs associated with equipment, and has given local franchising authorities power to review these determinations.

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[63] See 47 U.S.C. § 543(b)(3).

[64] Id.

Under the scheme, all cable operators are required to examine equipment purchase and installation records extending back indefinitely. Since the record-keeping requirement is new, there is no guarantee that adequate records even exist. Where they exist, the records may not be in usable form. Estimates and judgment calls are inevitable. The process will be time consuming and the calculations complex.

Some operators may, therefore, find the Commission's proposal to supplement system specific actual cost data with national or regional averages, or averages based on system characteristics, useful and time-saving. The needed information on costs is not, however, available. The Commission should provide additional time to permit interested parties to gather the necessary data. In the meantime, the Commission should suspend complaints alleging excess basic cable and cable program service rates in which operators indicate their intention to rely on average equipment costs.

This process should not be mandatory, however. Operators experiencing above average equipment costs should be permitted to justify a higher equipment rate component. Fairness and due process considerations require that the blunt instrument of averaging not result in the denial of a reasonable return.

D. The Alternative of Permitting Cable Systems to Justify Rates Based on Average Industry Costs Should Be Further Explored

The Commission also suggests that not only equipment cost showings but, indeed, overall cost-of-service showings could be simplified by permitting "cable operators to justify rates based on average costs of providing cable service . . . experienced by all systems, or of similar systems with specified defined characteristics. . ."[65] This approach is analogous to the regulatory treatment of the approximately 700 "average schedule" small telcos that ". . . file rates based not on their own costs, but on an average cost

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[65] NPRM at ¶ 74.

schedule."[66] The information needed to implement an average cost scheme would be derived from planned cost studies.

This alternative should be pursued. It is possible that some companies may find average costs a viable surrogate for actual costs of providing services. But until the planned cost studies are completed and commented upon, and the associated procedures are fully understood, the Commission cannot proceed. More fundamentally, however, a cable operator should not be required to use average costs where it chooses to put forward its actual costs. Every operator must be given the opportunity to justify its rates on the basis of the costs it actually incurs.

E. **The Other Simplification Alternatives Require Further Investigation**

The NPRM asks whether it would be appropriate to "establish an abbreviated cost-of-service showing for significant prospective capital expenditures used to improve the quality of service or to provide additional services."[67] It also asks if, as an alternative to cost-of-service showings, cable operators should be permitted "to document key cost factors, financial characteristics, or other combination of factors that could be said to justify existing rates."[68] Under either proposal, successful showings would result in authorizing "add-ons" to benchmark rates.

We believe that, for those operators who so elect, this simplification may be useful as part of an overall scheme. There may be advantages to conducting rate proceedings focused exclusively on particular elements of a cable system's costs.

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66 Id.

67 NPRM at ¶ 75 (citation omitted).

68 Id. at ¶ 72.

In pursuing these alternatives, however, the Commission will undoubtedly wish to avoid becoming the micro-manager of the cable industry. The Commission should not become involved in the examination of individual business decisions, such as whether a particular cable company ought to invest (or should be compensated for investment) in particular transmission equipment. Second-guessing decisions concerning equipment capable of delivering a given level of system capacity could, for example, result in de facto regulation of content by encouraging cable systems to limit choices to more popular programming. Limiting capacity can have a "chilling effect" on speech if it reduces the cable operator's incentives to offer greater diversity.

In any event, simplifications should not take the place of actual cost showings, should a company wish to make such showings.

VII. CABLE COMPANIES SHOULD BE GIVEN FLEXIBILITY IN BUSINESS OPERATIONS

The Commission seeks comment on several additional issues. These issues include:

- Cost Averaging;
- Adoption of a Uniform System of Accounts;
- Treatment of taxes.
- Affiliate Transactions

For the following reasons, cable operators should be given flexibility in each of these areas.

A. Cost Averaging

In the Report and Order, the Commission generally required cable systems to "aggregate expenses and revenues at either the franchise, system, regional, or company level in a manner consistent with the practices of the operators as of April 3, 1993."[69] The NPRM asks for comment on the possible mandating of cost aggregations above the franchise level, which could result in cost elements applied to an MSO on a regional or national basis. According to the Commission:

> [C]ost-of-service showings would be greatly simplified by using a unitary, industry-wide cost of capital; company-wide (MSO) average per subscriber rate base, operating expenses and depreciation; and franchise specific levies (taxes and obligations). The revenue requirement would be developed at total company level and the average per subscriber revenue requirement would be allocated to a specific franchise. The Commission would evaluate cable programming service rates subject to complaint, and local franchise authorities would evaluate basic tier rates, based on average per subscriber costs determined in accordance with Commission requirements plus franchise specific levies, divided by the number of channels providing tiered service.[70]

The result of this approach would be substantially similar rates across all of an MSO's operations.

Certain MSOs might elect to pursue this option. It should not be mandatory, however. Cost-of-service proceedings can be expensive and time-consuming, but if systems wish to show franchise-specific costs to justify franchise rates, they should not be denied that opportunity. Furthermore, MSOs own systems with widely varying characteristics -- large and small, urban and rural, advanced and traditional, 12 channels and hundreds of channels. The cable industry is beginning a period of rapid expansion in channel capacity and versatility. During this interim period, the differences among systems are likely to be greater than in recent years. While cost averaging may be appropriate in some cases, it is fundamentally unfair to subscribers and operators to force averaging. Forced averaging, if applied in the wrong circumstances, can easily result in

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[69] NPRM at ¶ 59. See 47 C.F.R. § 76.924(d).

[70] Id. at ¶ 61.

overcharges to some subscribers and subsidies to others, surely an undesired result of a system intended to produce cost-based rates.

B. Uniform System of Accounts

The Commission should not adopt a Uniform System of Accounts ("USOA") for cable. The experience in devising a USOA for telcos, which took nearly a decade, is indicative of the challenges that would be involved in establishing a new regulatory accounting scheme. Until a careful and comprehensive examination of accounting goals, methodology and structure can be undertaken, the Commission should allow the cable industry to account for costs in accordance with Generally Accepted Accounting Principles ("GAAP").[71]

GAAP accounting will permit the Commission and local franchising authorities to analyze financial data in a sufficiently standardized form. If situations arise in which further information is required, regulators can seek clarification. Should GAAP ultimately prove inadequate, the Commisison can begin the process of devising and implementing a cable USOA. But it would be an enormous, and unnecessary, administrative burden for cable operators at this point to modify and maintain their accounting systems in accordance with a Commission-prescribed USOA.

C. Income Tax Treatment

The Commission proposes to allow cable operators to include taxes incurred in the provision of regulated cable service in the determination of annual expenses. Taxes, for this purpose, include "all state and federal taxes on the provision of cable service and on income taxes attributable to the provision of regulated cable service."[72] The NPRM

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71 The Commission has already mandated in its rate regulation rules that cable operators generally must maintain their accounts in accordance with GAAP. 47 C.F.R. § 76.924(b).

72 NPRM at ¶ 30.

notes that "taxes" include only those levies "payable by the business entity. Income taxes payable on income from cable operations by individual owners, partners or Subchapter S Corporation owners would not be recoverable rates for regulated cable service."[73] This proposal to deny all tax recovery to cable operators using the individual, partnership or Subchapter S forms of organization, is clearly in error.

This complete disallowance of income tax expense incurred as a result of providing regulated service while using certain forms of business organization is completely at odds with basic ratemaking principles. Clearly, it would unfairly penalize noncorporate and Subchapter S cable operators. As Appendix D demonstrates, it would deny them returns comparable to corporate shareholders simply because of their form of organization. Taxes paid by a cable system, regardless of its form of doing business, are undoubtedly recoverable expenses under applicable precedent. The Supreme Court has made clear that "[a]ll taxes which would be payable if a fair return were earned are appropriate deductions [from gross revenue]. There is no difference in this respect between state and federal taxes or between income taxes and others."[74] Since most regulated public utilities are Chapter C corporations, regulators have not often been required to address the issue of income taxes paid by a regulated public utility operating in a noncorporate or Subchapter S form. But where that issue has arisen, several courts have held that such taxes should be recognized as an expense.

For example, in Suburban Utility Corporation, the Texas Supreme Court ruled that noncorporate taxes must be allowed as an expense for a Subchapter S Corporation so

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[73] Id. n.32.

[74] Galveston Electric Co. v. City of Galveston, 258 U.S. 388, 399 (1921); see also Fed. Power Comm. v. United Gas Pipe Line Co., 386 U.S. 237, 243 (1967) ("Normally included as a cost-of-service as a proper allowance for taxes, including federal income taxes.")

long as they did not exceed the tax expense which would be incurred under normal corporate form.[75] Similarly, in Vernah S. Moyston,[76] the New Mexico Supreme Court required sole proprietor taxes to be treated as an income tax expense. There is no reason for the Commission to adopt a different approach here that discriminates against these entities. Indeed, the provisions of the Tax Code concerning the pass through under Subchapter S were framed so that the form of organization would be controlled by business considerations, not tax concerns.[77] It would be contrary to Congress' intent in the tax laws to force an avoidance of Subchapter S organization due to regulatory treatment of taxes. Accordingly, any taxes reasonably incurred by an individual owner, partner, or Subchapter S owner of a cable system in connection with provision of cable service must be treated as allowable expenses in setting rates.

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75 652 S.W.2d 358 (Tex. 1983). The court found that "the income taxes required to be paid by shareholders of a Subchapter S corporation on a utility's income are inescapable business outlays and are directly comparable with similar corporate taxes which would have been imposed if the utility operations had been carried out by a corporation. Their elimination from cost of service is no less capricious than the excising of salaries paid to a utilities would be. We therefore hold that Suburban is entitled to a reasonable cost of service allowance for federal income taxes actually paid by its shareholders on Suburban's taxable income or for taxes it would be required to pay as a conventional corporation, whichever is less."

76 Vernah S. Moyston v. New Mexico Public Services Commission, 76 N.M. 146, 412 P.2d 840, 846-51 (N.M. 1966).

77 S. Rep. No. 1983, 85th Cong. 2d Sess. (1958), reprinted in 1958 U.S. Code Cong. & Admin. News 4791, 4876.

D. **Affiliate Transactions Should Not Be Regulated**

The Commission proposes to treat transactions involving affiliates and non-affiliates differently.[78] Specifically, while cable operators would be entitled to recover the actual cost of a service, or revenue earned for providing a service by non-affiliates, the Notice proposes to adopt rules governing the value of affiliate transactions.

There is no need to adopt these measures. While the Commission has rules addressing affiliate transactions for common carriers, these are designed to address very real concerns about the reliability of costs assigned to the carriers' regulated activities where they were vertically integrated into equipment manufacturing and non-regulated activities. There is no history of cable operator cross-subsidization, and no evidence that this would be the case. Cable operators do not generally have affiliated vendors of equipment or other items except programming. Any abuse of affiliated programming costs would be easily detectable in a cost-of-service showing.

Accordingly, the Commission should not adopt any affiliate transaction rules at this time. If, after monitoring these costs, a pattern of problems in this area can be found, then the Commission could adopt narrow rules to address possible abuses. But the Notice identifies no reason to believe that this is currently a problem and accordingly there is no need to impose even more regulatory recordkeeping requirements.

CONCLUSION

The Commission is faced with the task of adopting cost of service rules in a unique circumstance. It cannot and should not blindly impose all the standards and trappings of utility ratemaking on an industry for which those standards and trappings are, for the foregoing reasons, wholly inappropriate. Instead, it should establish certain principles, consistent with our comments herein, that will allow cable operators a full

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[78] Notice, ¶ 67.

opportunity to demonstrate the reasonableness of their rates based on their costs. Future refinements of these rules should take place only after further experience is gained and a meaningful transition afforded operators.

Respectfully submitted,

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APPENDIX A

Prices Above Book Values Do Not Imply Market Power

I. Introduction

The Commission has tentatively decided to "adopt an original cost methodology to determine the value of a cable operator's plant in service for rate base purposes," and to exclude "excess acquisition costs from rate base, including portions assigned to goodwill, customer lists, franchise rights, and other intangible assets."[1] This decision seems to be based on the view that any acquisition value above original cost is an indication of monopoly rents and, therefore, should not be included in the rate base.

This paper presents evidence to the contrary. We analyze the reasons why the market value of assets would be expected to exceed book value whether an industry is competitive or not. We examine the average annual market-to-book equity ratios for S&P 500 firms from 1977 to 1992, showing that the average ratio always exceeds one.

Finally, we examine the harm that will be caused if the Commission adopts an original cost rate base, or any other rate base that does not reflect the value of intangible assets. An insufficient rate base will cause under-investment in the future and will encourage degradation of existing assets, to the detriment of consumers.

II. Market prices differ from book values for a variety of reasons

A firm's assets are commonly categorized as tangible or intangible. Physical capital is a tangible asset; the remaining value of the firm constitutes intangible assets. Intangible assets can comprise a large and vital part of a firm's investment. Intangible assets have been defined as the

1 FCC, "Notice of Proposed Rulemaking," MM Docket No. 93-215, July 15, 1993, paragraph 35.